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MAR 10 1993

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Simplification of the Depreciation Prescription Process	)	CC Docket No. 92-296
	)	
	)	

Comments of the Ameritech Operating Companies

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SUMMARY

The Ameritech Operating Companies respectfully submit comments on the Commission's proposed plans for depreciation simplification set forth in its Depreciation NPRM. The Companies strongly support the Commission's conclusion that the depreciation process must be simplified. Specifically, the Commission's Price Cap Carrier option provides the most benefits by saving administrative time and costs while continuing to ensure that local exchange carriers (LECs) reflect realistic depreciation rates. The other three options as described in the NPRM, which establish specific ranges for certain factors used in calculating depreciation rates, provide only limited benefits and, in some circumstances, quite possibly provide no benefits at all.

In these comments, the Companies have demonstrated that the Price Cap option will provide the most public interest benefits while still ensuring reasonable depreciation rates. Specifically, the Commission will still review the proposed depreciation rates of all LECs before prescribing the appropriate rate. In addition, the Commission will have depreciation information from the entire telecommunications industry which uses the same equipment as well as comments from state commissions and interested ratepayers before prescribing reasonable depreciation rates. Furthermore there are several safeguards -- in addition to Commission review -- which ensure that LECs will propose realistic depreciation rates and will not manipulate depreciation rates because of the sharing mechanism. Finally, the information filed by LECs in the Commission required reports is used neither by the Commission nor the Companies for estimating appropriate depreciation rates. Thus, the streamlined process under the Price Cap option would provide as much useful information to the Commission in establishing depreciation rates as the current depreciation process.

Consequently, with the rapid changes occurring in the telecommunications industry, the depreciation process must be simplified and LECs are in the best position to determine appropriate depreciation rates. The Price Cap Carrier option is the best alternative because it provides the most public interest benefits by simplifying the depreciation process, reducing administrative costs and giving appropriate weight to LECs' decisions on depreciation rates.

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The Ameritech Operating Companies (or Companies)[1], pursuant to §1.415 of the Federal Communications Commission's (Commission) Rules, 47 C.F.R. §1.415, respectfully submit these comments on the Commission's proposed plans for depreciation simplification set forth in its Depreciation NPRM.[2] In these comments, the Companies strongly support the Commission's conclusion that the depreciation process must be simplified. Specifically, the Commission's Price Cap Carrier option provides the most benefits by saving administrative time and costs while continuing to ensure that local exchange carriers (LECs) reflect realistic depreciation rates. The other three options as described in the NPRM, which establish specific ranges for certain factors used in calculating depreciation rates, provide only limited benefits and, in some circumstances, quite possibly provide no benefits at all.

I. There is a Need for Depreciation Reform

As the Commission acknowledged in its Depreciation NPRM, the Commission's current depreciation process needs simplifying. The Commission currently prescribes depreciation rates based on a complex process which

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[1] The Ameritech Operating Companies are: Illinois Bell Telephone Co., Indiana Bell Telephone Co., Inc., Michigan Bell Telephone Co., The Ohio Bell Telephone Co., and Wisconsin Bell, Inc.

[2] *See Simplification of the Depreciation Prescription Process*, CC Dkt. No. 92-296, FCC 92-537, 7 FCC Rcd. (1992) (Depreciation NPRM).

requires it to determine the appropriate value of future net salvage and average remaining life for each LEC for each depreciable rate category. The average remaining life is composed of two additional factors which also must be studied: projection life and a survivor curve. As part of this complex process, LECs must conduct detailed studies of the projection life and salvage values, among other things, of these 30 to 40 categories of depreciable property.[3] These studies require a large amount of effort and expense by each LEC and typically result in a 500+ page report filed with the Commission. At the same time they file their studies, LECs propose the depreciation rates they should be allowed to use in the following three years for each rate category. It is estimated that the process of completing these reports costs the industry approximately $35 to $50 million annually.[4]

In addition to being expensive and time consuming, the usefulness of these studies is questionable. The Commission has consistently rejected the depreciation rates suggested by the Companies as the basis for depreciation prescriptions, and seldom use the information the Commission requires to be filed in the reports. For example, an analysis of the Companies' submitted depreciation rate studies for 1991 through 1993 shows that the Commission never considers mortality factors in choosing the appropriate depreciation rate in over one third of the prescribed depreciation rates. Moreover, the Commission prescribed life projections for the Companies' accounts that were within +/- 25 percent of the historical mortality factors less than 30 percent of the time.[5]

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[3] The Commission issues an annual Depreciation Study Guide which delineates the studies LECs are required to complete and report to the Commission. *See e.g.*, The Federal Communications Commission Depreciation Study Guide, 1993.

[4] Depreciation NPRM, *supra* note 2, at ¶ 8.

[5] Similarly, the Commission has approved only a portion of the depreciation amounts requested by other LECs. *See Prescription of Revised Percentages of Depreciation pursuant to the Communications*

Further, the Companies themselves do not rely on the information contained in the studies to determine their estimates of appropriate depreciation rates. Instead, the Companies provide the Commission estimates of their depreciation rates based on other analyses, such as technology substitution forecasts and product life cycle forecasts. Consequently, the date required by the Commission's studies are used by neither the Commission nor the Companies and therefore should be discontinued.

Moreover, the significant changes to the telecommunications industry require the Commission's depreciation practices to be reformed. Most importantly, the industry is becoming increasingly competitive and carriers, including LECs, now compete for customers in all service areas, including long distance, cellular, enhanced telecommunication, and local and long distance business services.[6] In this regard, the Commission recently ordered Tier I LECs to offer expanded interconnection to their special access facilities by May 1, 1993. This interconnection requirement permits LEC competitors and high volume users to terminate their high volume transmission facilities at the LEC central offices.[7] The Commission also proposes to require all Tier I LECs to offer expanded interconnection for the provision of switched transport to be effective in November, 1993.[8] And, finally, the Commission proposes to require LECs to provide certain signaling and other functionalities so that CAPs and others could

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Act of 1934 as amended for Alascom, Inc., et al., Petition for Reconsideration filed by Southwestern Bell, at 12 Table 4, March 2, 1992.

[6] For a more complete discussion on competition in the telecommunications industry, see Petition for Declaratory Ruling and Related Waivers to Establish a New Regulatory Model for the Ameritech Region, filed by Ameritech Corporation, March 1, 1993 at 5-10.

[7] *See Expanded Interconnection with Local Telephone Company Facilities,* 7 FCC Rcd. 7369 (1992).

[8] *See Expanded Interconnection with Local Telephone Company Facilities,* 7 FCC Rcd. 7740 (1992).

perform functions similar to LECs' access tandem switches.[9] Despite the fact that competitors will have open access to the LECs' networks to compete for customers, LEC competitors do not have the regulatory process --particularly the expensive depreciation prescription process -- imposing unnecessary administrative costs on their businesses.

Furthermore, rapid technological advances in the industry, which LECs must deploy to remain competitive, shorten the projection lives of LEC embedded investment thereby limiting the time over which LECs have the opportunity to recover their capital investment.[10]

In addition to these changes in the communications marketplace, the interstate regulatory environment has undergone significant restructuring. The Commission instituted incentive regulation, *i.e.*, price caps, for the largest LECs. The plan provides a ceiling, or cap, on the prices LECs can charge for their interstate service offerings so that the Commission no longer needs detailed review of LECs' expenses or revenue requirements. Essentially under price caps, the link between costs and price is broken and revenue requirements cease to exist. In return for incentive regulation, LECs that outperform the productivity level embedded in the annual adjustment mechanism are able to retain greater earnings than would be available under the former regulatory system.[11]

Consequently, all these changes in the telecommunications industry -- competition, technological advances, price cap regulation -- create a critical need to change the outmoded depreciation process. These depreciation practices must

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[9] *Id.*

[10] Technologies such as digital switching and fiber optics give rise to other technological advances such as ISDN and Signaling System 7, which provide additional functionalities that are in demand.

[11] *Policy and Rules Concerning Rates for Dominant Carriers*, 5 FCC Rcd. 6786 (1990), *recon.*, 6 FCC Rcd. 2637 (1991).

be simplified to provide administrative savings and modified to allow LECs to reflect a more realistic rate of consumption of telecommunications equipment.

II. The Commission Should Adopt the Price Cap Carrier Option

The Companies strongly recommend that the Commission adopt the Price Cap Carrier option for depreciation simplification. This option provides the most benefits to be realized through depreciation simplification. Under this plan, LECs would file with the Commission: their currently prescribed depreciation rates; their proposed depreciation rates; and the changes in depreciation expense that would occur when the Commission prescribes the LECs' proposed rates. The proposed rates would be placed on public notice and all interested parties, including state commissions, would have the opportunity to comment. The Commission then would prescribe depreciation rates based on the proposed rates and the comments on those rates.

This Price Cap option allows LECs and the Commission to dispense with the costly and unnecessarily detailed study-and-report process. The Ameritech Companies estimate that under the Price Cap option they will realize a savings of approximately $2 million dollars annually, and be able to reduce their depreciation costs by more than 50 percent if the option is used for all accounts.

Furthermore, this option advances the Commission's goals under price cap regulation, because depreciation expenses are treated endogenously and changes in depreciation rates will not impact LECs' prices. Thus, as with other expenses, LECs will have incentives to use the most efficient process to determine their depreciation rates. More importantly, LECs will have incentives to deploy the most efficient and productive technology available because productivity gains will enable LECs to retain greater earnings.

In addition, LECs have little incentive or opportunity to adjust depreciation to avoid sharing under price caps. If LECs artificially lower depreciation rates thereby increasing short term earnings, under the sharing mechanism, they effectively give up recovery of one half of that investment. Likewise, if LECs artificially increase depreciation rates thereby decreasing short term earnings, they will unnecessarily increase their cost of capital when competition and price caps will not allow them to increase their prices to adjust for those increased capital cost estimates. Furthermore, LECs will have precluded recovery of that investment, most of which was placed into service under rate of return regulation.

Also, there are additional constraints and reporting requirements that ensure both the appropriate determination and accurate recording of depreciation expenses even with the sharing mechanism of price caps. First, LECs are bound to follow Generally Accepted Accounting Principles (GAAP) that provide guidelines under which sound accounting and depreciation practices are determined. The Commission has recognized the importance of GAAP for regulatory accounting purposes and has committed to adopting GAAP to the extent regulatory considerations permit. As previously demonstrated, regulatory considerations provide for GAAP accounting in setting depreciation rates. Second, the Companies must file financial statements with the Securities and Exchange Commission (SEC) which requires that the financial statements be prepared according to GAAP with appropriate footnotes and disclosures explaining the statement to ensure an accurate portrayal of the financial position of the company.[12] Third, the preparation of these financial statements must be audited by independent accounting firms which issue an opinion on whether the statements were prepared in accordance with GAAP.

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[12] The SEC also has statutory authority to bring a suit for civil and criminal penalties against any company whose financial statements misrepresent the financial position of the company. *See* Securities Exchange Act of 1934 §§ 10(b), 13(a), and 18(a), 5 U.S.C. §§78j(b), 78m(a), and 78r(a).

Finally, the Commission still will review the LECs' proposed depreciation expenses and prescribe depreciation rates. The Commission will review LECs' proposed rates as well as all comments on those rates from interested parties. Based on that record, the Commission has sufficient information to determine whether the proposed depreciation rates are reasonable. In this regard, the Commission will have depreciation rates for all LECs and for other telecommunications companies. Moreover, the Commission will have the financial data of LECs available through the ARMIS reports. If the Commission is concerned the a LEC is proposing depreciation rates which do not seem reasonable, the Commission has the ability to request additional information about the LEC's proposed rates.[13] Under the Price Cap option, therefore, there are sufficient incentives and controls to ensure LECs accurately report depreciation rates.

The Commission will not abrogate its responsibility under §220(b) of the Communications Act of 1934 by adopting this streamlined approach to the depreciation process. As explained above, the Commission will still review *and prescribe* depreciation rates after determining that they are reasonable. Under this option, the Commission will give greater weight to the LECs' determination of the appropriate depreciation rates pursuant to all the constraints mentioned above.

Moreover, the Commission fulfills its obligation under §220(i) of the Communications Act under the Price Cap option by providing state commissions public notice of the proposed depreciation rates. Section 220(i) only requires that

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[13] Interestingly, the depreciation rates of other telecommunications companies even those subject to the Commission's depreciation practices, such as interexchange carriers, are noticeably greater than the prescribed depreciation rates of the LECs. For example, AT&T's prescribed depreciation rates are 13.8 percent as compared to approximately 6.5 to 7.0 percent for most of the price cap LECs.

the state commissions be given a reasonable opportunity to present their views. In addition, pursuant to the Supreme Court's decision in *Louisiana Public Service Commission v. FCC,*[14] the Commission's depreciation prescriptions are not binding on state commissions. State commissions prescribe their own depreciation rates and practices. Thus, since the Commission's depreciation prescriptions do not affect the state commissions' prescriptions, there is no need for three-way meetings.

In summary, the Companies have addressed each of Commissioner Duggan's stated concerns and demonstrated that the Price Cap option will provide the most public interest benefits while still ensuring reasonable depreciation rates.[15] Specifically, the Commission will still review the proposed depreciation rates of all LECs before prescribing the appropriate rate. In addition, the Commission will have depreciation information from the entire telecommunications industry which uses the same equipment as well as comments from state commissions and interested ratepayers before prescribing rates. Furthermore there are several safeguards -- in addition to Commission review -- which ensure that LECs will propose realistic depreciation rates and will not manipulate depreciation rates because of the sharing mechanism. Finally, as noted above, the information filed by LECs in the Commission required reports is used neither by the Commission nor the Companies for estimating appropriate depreciation rates. Thus, the streamlined process under the Price Cap option will provide as much useful information to the Commission in establishing depreciation rates as the current depreciation process.

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14 *Louisiana Public Service Commission v. FCC*, 476 U.S. 355 (1986).

15 *See* Concurring Statement of Commissioner Duggan, Depreciation NPRM *supra* note 2, December 10, 1992.

Consequently, with the rapid changes occurring in the telecommunications industry, the depreciation process must be simplified and LECs are in the best position to determine appropriate depreciation rates. The Price Cap Carrier option is the best alternative because it provides the most public interest benefits by simplifying the depreciation process, reducing administrative costs and giving appropriate weight to LECs' decisions on depreciation rates.

III. The Commission Should Reject the Other Proposed Options

The other three options proposed in the Commission's Depreciation NPRM generally provide for the establishment of a set of ranges for specific depreciation factors from which LECs can choose and use to calculate their depreciation expense. In the Base Factor Range option, the Commission would establish a set of ranges for several of the underlying factors used to determine the depreciation rates for depreciable accounts. In the Depreciation Rate Range option, the Commission would establish a range of depreciation rates for certain accounts, and LECs would apply a depreciation rate from the allowed range to the plant account balance to determine the allowable depreciation expense for that account. In the Depreciation Schedule option, the Commission would establish depreciation schedules based on the average service lives, retirement patterns, and salvage values for each account. LECs would apply these specified schedules to investments in each account by vintage.

As currently proposed, none of these options offer the amount of simplification and cost savings available in the Price Cap option because they are based on the Commission's complex depreciation process. The Companies estimate that these alternatives provide less than one half of the savings available under the Price Cap option, even if the Commission establishes ranges for all accounts. And, if the Commission only mandates ranges for some accounts, the savings will be diminished.

While the Depreciation Rate Range option is the best alternative of the three range options, it is essentially as flawed as the other two options. First, the Commission proposes that the appropriate ranges for the three alternatives be based on a statistical analysis of the currently prescribed depreciation rates, with an allowed range of plus or minus one standard deviation. Such a narrow range merely rubber stamps the Commission's currently prescribed depreciation rates into the depreciation process and gives no weight to the proposed rates provided by LECs. In fact, this proposal merely pulls all LECs closer to an established industry mean. Should LECs need to deviate from these narrow ranges -- which is highly likely -- LECs would have to continue their attempts to demonstrate to the Commission the need to use depreciation rates different from the range available.[16]

Second, the Commission does not propose to establish ranges for all depreciable accounts under the three alternatives. Rather, the Commission would establish ranges for specific accounts and maintain the current process for the remaining accounts. Again, under these options LECs would be required to continue the cumbersome study and report process for those accounts not subject to the simplification process. Third, the Commission proposes to establish separate depreciation ranges for the interexchange carriers and the LECs. However the interexchange carriers use the same equipment as the LEC, *i.e.*, digital switches, copper cable, and fiber optics. There is no sound logical or economic reason -- given the competition the LECs are confronting in the telecommunications industry -- to conclude that the investment of interexchange

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[16] In fact, even though the studies filed with the Commission are used by neither the Commission nor the Companies, in all likelihood the Commission would require LECs to complete and file the presently required studies if they tried to deviate from the established range.

carriers could have substantially different depreciation rates than similar investment by LECs.

If the Commission adopts one of the range options, however, it should adopt the Depreciation Rate Range option. By establishing a single range of depreciation rates for depreciable accounts, rather than establishing numerous ranges for several factors used to calculate depreciation rates, this alternative simplifies the process more than the other two alternatives. However, in order to make the Depreciation Rate Range option work best, the Commission must establish one set of depreciation rate ranges for both interexchange carriers and LECs and those ranges must be sufficient to allow LECs to reflect realistic depreciation expenses. These criteria are necessary for the Depreciation Rate Range option to have enough simplification of the depreciation process to provide adequate administrative savings.

IV. Salvage

The Commission requests comment on whether it should eliminate salvage as a consideration in calculating depreciation rates to provide additional simplification of the depreciation process. The Companies would realize an increase in reported net income this year if the Commission changed its treatment of salvage.[17] However, GAAP requires salvage and cost of removal of equipment to be considered in the depreciation process subject to the determination of materiality. Specifically, the accrual method of accounting

[17] There is no guarantee that this treatment of salvage will always result in an increase in net income for the Companies. Actually, net income will be identical over the long run but administrative costs can be reduced with simplified accounting treatment.

requires the Companies to spread the credit for salvage and the removal cost over the life of the asset when the amounts are significant. Nevertheless, consideration of current accounting treatment for salvage and costs of removal should be carefully examined on an account by account basis and implemented for those accounts where the amounts are not material. This examination should be completed independent of the depreciation simplification issues raised herein.

V. Conclusion

Based on the foregoing, the Commission should adopt the Price Cap option for depreciation simplification because it provides the most public interest benefits while not compromising the Commission's responsibility to approve the prescribed rates.

Respectfully submitted,

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